

Internal Revenue Service
memorandum

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FS:IT&A:MLOsborne

date: DEC 23 1991
to: District Counsel, Sacramento
Attn: Bruce E. Gardner

from: Associate Chief Counsel, Field Service Division

subject: LIFO Pools and Items in the Wine Industry

This is in response to your request for Technical Advice dated September 26, 1991.

We have relied on some of the facts set forth in your advice to Examination. We have also assumed that the wineries under discussion grow or purchase, process, package, and sell the final product. Our discussion focuses on wineries who use the dollar value LIFO method to value their inventories.

ISSUE

Under I.R.C. § 472, does a winery on the dollar value LIFO method more clearly reflect income by placing its inventory in one pool with separate items for each of its grape varieties or by placing each separate grape variety in multiple pools.¹

CONCLUSION

A winery using the dollar value LIFO method should treat its wine making process as a natural business unit pool under Treas. Reg. § 1.472-8(b), with the various grape varieties treated as separate items within the natural business unit pool.

FACTS

There are three different grades of wine produced by the wine industry and many wineries produce a combination of all three different grades of wine. The first is a low grade wine in which taste is not important; the relevant element is that the product contain some alcoholic content. The second product is commonly known as "jug wine" or generic type wine. The third product consists of premium and ultra premium wines. The

¹ "Grape varieties" for purposes of this memorandum refers to varietal crushes such as white riesling, chardonnay, zinfandel, white zinfandel, merlot, etc. It does not refer to the three grades of wine.

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distinguishing features between these three grades of wine are the cost of production, taste, and time it takes to bring each to market.

The Central Valley of California is where the grapes for the low grade wine are grown. The jug or generic wines are produced by vineyards who blend cheap grapes with a higher quality grape. There is no requirement that the grapes be of a certain type or that the wine contain specific percentages of any particular grape. The premium varietal wines must contain expensive grapes and these grapes must be a least 75% of that particular varietal grape to be marketed as that varietal (such as cabernet sauvignon).

The cost to produce and purchase the lower grade varietal wine, such as white zinfandel, is low and production takes about two weeks. The production costs for premium wines, such as carbernet sauvignon, are higher because close controls are maintained on the sugar acid content which determines the style and taste of the final product.

The manufacturing process varies for each grade of wine and type of wine. Some wines are fermented in steel tanks while the premium white and red wines are fermented in large redwood tanks or oak barrels. The storage of the premium wines in the oak barrel enhances the aging process. White wine takes about six months to twelve months to age. Red wines, on the other hand, take twelve to twenty-four months. An aging process also occurs when the wine is bottled and corked. For white wines it is three to six months and for red it is one to two years.

Most of the wine industry uses the LIFO dollar value method to value its inventory. The inventory a winery manufactures is diverse. That inventory may include the following varietals subject to noted production processes and associated costs.

<u>Varietal crush</u>	<u>Cost/Ton</u> ²	<u>BF</u> ³	<u>BA</u> ⁴	<u>Approximate months to release after crush</u>
White Riesling	363			9
Chardonnay	921	X		18
Sauvignon Blanc	413	X		9
Gewurztraminer	410			9
Cabernet Sauvignon	630	X	X	30
Merlot	766		X	18-24
Pinot Noir	573		X	24
Zinfandel	480		X	18-24

The barrels used in fermenting and aging are American and French Oak. The average cost of the American barrels is \$100 per barrel and of the French barrels is \$400 per barrel. The average life of these barrels is three years.

Wineries are required to keep track of varietal gallons for the Bureau of Alcohol, Tobacco, and Firearms (ATF) if the wine label bears a varietal name. Most winery inventory records are extensive and already track costs on a LIFO basis.

The months from crush to release require direct and indirect costs to accumulate for each varietal. The wine must be moved from barrel to barrel in an attempt to maximize the use of the facilities and to prevent the oxidation of product through "lees removal." The wine is also moved to minimize evaporation within the barrels and limit subsequent exposure to outside air.

In applying the LIFO valuation methods, some of the wineries using the dollar value LIFO method mix the bulk, jug, and premium wines and treat them either as one item or one pool. The total tax value is divided by the gallons on hand as of the end of year

² Initial grape cost is from the 1989 Grape Crush Report (1988 crush); cost is per ton based upon state-wide prices. Cost/Ton can vary substantially from District to District. (Ex: Sonoma County price for chardonnay = \$900 to \$1750/ton)

³ BF: Barrel fermented

⁴ BA: Barrel aged

with decrements to this layer calculated at average cost per gallon, regardless of varietal. If an increment occurs, it may be valued at earliest acquisition cost, average cost, or last acquisition cost, regardless of varietal. This can result in distortion, as some varieties escape certain processing costs which apply to only that type of varietal. This skewing effect of determining cost under LIFO is not due to inflationary factors but is based on processing differences between varieties.

DISCUSSION

There are two principal methods of calculating the closing inventory under the LIFO convention permitted in the regulations: the specific goods method, a measure of inventory in terms of physical units of inventory, and the dollar value method, a measure of inventory in terms of dollars. Treas. Reg. § 1.472-2 and Treas. Reg. § 1.472-8, respectively. We limit our discussion to wineries using the dollar value method.

Under the dollar value method, inventory is grouped into "pools" composed of "items" for purposes of calculating changes in the dollar value of inventory carried. In order to determine whether inventory has increased or decreased during the year, ending inventory is valued in dollars equivalent in value to the dollars used to value beginning inventory. See generally Treas. Reg. § 1.472-8 and Amity Leather Products Co. v. Commissioner, 82 T.C. 726 (1984).

Treas. Reg. § 1.472-8(b)(1) identifies principles for establishing pools for manufacturers and processors. The regulation states that a pool shall consist of all items entering into the entire inventory investment for a natural business unit of a business enterprise. Treas. Reg. § 1.472-8(b)(1) further states that if a business enterprise is composed of only one natural business unit, one pool shall be used for all of its inventories, including raw materials, goods in process, and finished goods.

In the case of a manufacturer or processor, a natural business unit ordinarily consists of the entire productive activity of the enterprise within one product line or within two or more related product lines, including the obtaining of materials, the processing of materials, and the selling of manufactured or processed goods. Treas. Reg. § 1.472-8(b)(2).

The harvesting or purchasing of the grapes, the crushing and processing and mixing of the grapes into the three grades of wine, the aging and fermenting of the individual varieties, and the ultimate bottling or packaging of the wine encompass the entire productive activity of a winery. Thus, in general, the entire manufacturing and processing of grapes into wine is composed of only one natural business unit. Consequently, for

those wineries where the business enterprise is composed of only one natural business unit, one pool shall be used for all its inventories, including raw materials, goods in process, and finished goods.

Having determined from the facts and analysis that, for most wineries, one natural business unit pool is to be used, the important issue is the definition of "item" within this natural business unit pool. As you correctly noted, the term item is not defined in either the Code or the regulations. Two cases have dealt with the term item in the context of a manufacturing business. Amity Leather, 82 T.C. 726; Hamilton Industries, Inc. v. Commissioner, 97 T.C. 120 (1991).

In Amity Leather, the court stated:

The nature of "items" in a pool must be similar enough to allow a comparison between ending inventory and base-year inventory. Because the change in the price of an item determines the price index and the index affects the computation of increments or decrements in the LIFO inventory, the definition and scope of an item are extremely important to the clear reflection of income. If factors other than inflation enter into the cost of inventory items, a reliable index cannot be computed...

A narrower definition of an item within a pool will generally lead to a more accurate measure of inflation (i.e., price index) and thereby lead to a clearer reflection of income. At the same time, the method of inventory accounting must be administratively feasible and not unduly burdensome from the standpoint of each of the parties...

Amity Leather, 82 T.C. at 733-734.

In Hamilton Industries, the court, following precedent in UFE, Inc. v. Commissioner, 92 T.C. 1314 (1989), refused to apply separate pooling to a taxpayer's purchased inventory where such purchase occurred as part of the acquisition of a manufacturing business which the taxpayer then continued. However, with respect to the treatment of this inventory as a separate item in the taxpayer's LIFO inventory pool, the court held that the inventory was purchased at such a substantial discount that it possessed materially different cost characteristics from inventory purchased or produced after the acquisition. Accordingly, the court held that the inventory must be treated as a separate item. Hamilton Industries, 97 T.C. at 139.

Generally, each varietal of grape should be treated as a separate item within the natural business unit pool of a winery. We believe that where each grape varietal possesses sufficient materially different cost characteristics from each other, each varietal should be treated as a separate item. For example (assuming materially different cost characteristics), the varietal chardonnay is a different item from the varietal cabernet sauvignon. Further, a cabernet sauvignon varietal grown (or purchased) in the Central Valley used in jug wine may be a separate item from a cabernet sauvignon varietal that is included as a premium wine, as the premium wine cabernet sauvignon may have a significantly different cost characteristics owing to the felicity of geography, the richness of the soil, or the combination of sugar and acids within the grape.

Having each varietal treated as a separate item should result in a more accurate reflection of inflation and lead to a clearer reflection of income, as it prevents non-inflationary distortions which might result from including a premium varietal such as cabernet sauvignon in the same item calculation as a less expensive varietal like white zinfandel.

Furthermore, given the significance of purity in enology, most wineries maintain extensive inventory records that track the costs of processing the grapes into wine. In addition, if the wine label bears a varietal name, the wineries must keep track of varietal gallons for the ATF. Thus, no additional administrative burden would be placed on the wine industry to identify each varietal of grape as a separate item in the natural business unit pool of the individual winery.

Whether each grape varietal should be treated as a separate item is essentially a question of fact. If Examination has specific questions relating to a specific taxpayer, we recommend requesting additional National Office assistance at that time.

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If you have any questions, please call Duke Osborne at FTS 566-3521.

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